TAN LAI

v.

MOHAMED MAHMUD & ORS.

HIGH COURT MALAYA, KUALA TERENGGANU
SALLEH ABAS FJ
[CIVIL SUIT NO. 106 OF 1974]
26 AUGUST & 14 SEPTEMBER 1981

CONTRACT: *Illegality - Assignment of rights given under timber licence - Company operating sawmill almost wholly owned by non-licensee - Whether subsequent agreement to sell shares to licensee also illegal - Whether claim under said subsequent agreements wholly independent of the illegal contracts Whether the maxim ex turpi causa non oritur actio applies.*

COMPANY LAW: *Incorporation - Effect of - Whether company is a body corporate subsequent to registration under Companies Act notwithstanding that agreements leading to incorporation were illegal - Whether validity of company's existence may be challenged subsequent to issuance of certificate of incorporation - Companies Act 1960, s. 361.*

CONTRACT: *Illegality - Assignment of rights given under timber licence - Company operating sawmill almost wholly owned by non-licensee - Whether agreements leading to incorporation of said company illegal - Whether any claims pursuant to these agreements sustainable.*

CONTRACT: *Illegality - Assignment of rights given under timber licence - Company operating sawmill almost wholly owned by non-licensee - Whether company liable to punishment.*

The plaintiff sued for the recovery of a sum which he alleged was the outstanding balance due to him pursuant to two agreements, one being an agreement for the sale of his shares to the first defendant and the second being a guarantee agreement entered into with all the defendants as a result of the first defendant's inability to make immediate payments for the said shares (hereinafter collectively referred to as "the said agreements"). The material facts leading to the present suit are as follows. The first defendant and another party ("the licensees") had obtained a sawmill licence which authorises the licensee to erect and/or operate a sawmill at a site specified therein. Subsequently, the licensees entered into two agreements with the plaintiff whereby the incorporation of a company to work the said sawmill licence was mandated. The company was incorporated and it had been operating a sawmill presumably relying upon the license. The plaintiff had a 75% share-holding in the company and it was agreed that he was to be solely responsible for the management and control of the company. Some time later, however, the plaintiff opted out of the company by selling all his shares in the company to the first defendant and it was further to this that the plaintiff entered into the said agreements, upon which the plaintiff's claim rests.

The defendants contend that the said agreements were illegal and thus they claim that this suit should be dismissed. The defendants also initially counterclaimed for the return of a certain sum which they had already paid to the plaintiff on the ground that the payment was made under a mistake of law. Subsequently, however, they dropped this counterclaim. It was a fact that the license issued to the licensees were strictly non-transferable and it was pursuant to this fact that the defendants contended as they did. It was submitted that the fact that

the license was not transferable compounded with the fact that the company was not authorised by the licence to operate a sawmill, renders the two agreements pursuant to which the company was formed illegal and therefore the incorporation of the company itself was illegal.

Based on the facts as above stated, the Court had to determine the issue of whether the said agreements were illegal.

Held:

[1] The dropping of the counterclaim was properly done because if the payment was made under an illegal contract as contended, under no circumstances can that same contract be relied upon to recover the amount so paid.

[2] Had the licensees owned and managed the company, by lifting the corporate veil, it could be held that they had erected and operated the sawmill and that the company's operation was within the terms of the licence. But where the company was virtually wholly owned by the plaintiff and completely managed by him, the licensees could not be held to have erected and operated the sawmill and consequently the company could not be held to have operated within the terms of the licence as it was not authorised by it, nor did it permit its transferability to the company. Therefore, the agreements pursuant to which the company was incorporated amounted to an attempt to circumvent the condition of the licence as to its non-transferability to non-licensees, and it follows that these agreements were illegal.

[3] The company is not the creature of the agreements pursuant to which the company was incorporated, although the parties thereto agreed that it should be incorporated. The existence of the company is the result of the statutory acts of the Registrar of the Companies under s. 16 of the Companies Act in registering the company and its memorandum and articles and in issuing a certificate of its incorporation. The effect of these acts is that as from the date specified in the certificate, the subscribers become a "body corporate" capable forthwith of exercising the functions of an incorporated company.

[4] Section 361 of the Companies Act makes it impossible for anyone to challenge the lawfulness and validity of the existence of the company although it does not go so far as to say that the company's objects and powers contained in the memorandum are either lawful or lawfully exercisable. A certificate of incorporation prevents any doubt from being cast upon the legal existence and the personal of the company but it does not validate its illegal objects.

[5] A company pursuing an illegal object should not be registered and the Registrar is entitlted to refuse the registration of such a company and his refusal is reviewable upon an application on mandamus, but once the company is registered, the Court has to accept and recognise its valid and lawful existence until it is wound up or until its registration is cancelled at the suit of the Attorney-General on account of its registration for an illegal object.

[6] The company's operation of the sawmill, being an operation without licence as required by r. 20(1) of the Terengganu Forest Rules 1356, is illegal and the company may well be liable to be punished by daily fines as provided in r. 20(4).

[7] The licence was not issued to the plaintiff nor could it be transferred to him, and as the plaintiff by virtue of his full control and shareholding is in fact the alter ego of the company, the operation of the sawmill when the company was thus constituted is illegal; the elements of illegality being the plaintiff's full control and management as well as shareholding in the company vis-a-vis the licence.

[8] As regards the sale of the shares, there is nothing illegal in the transaction. There is nothing illegal about its capital structure and the plaintiff's share holding as the company is validly incorporated and has a valid existence. The previous agreements following which the company was formed were irrelevant and could not render the plaintiff's share ownership in the company illegal. Therefore the subsequent sale of the shares by the plaintiff to the first defendant and the guarantee given by the three other defendants against failure of the first defendant to pay the price of these shares (i.e. the said agreements) were also not illegal.

[9] Where the plaintiff's claim is wholly independent of the alleged illegal contracts, there is no question of applying the maxim *ex turpi causa non oritur actio*.

[Judgment entered for the plaintiff in the sum claimed and costs.]

Cases referred to:
R. v. Registrar of Joint Stock Companies [1931] 2 KB 197
Bowmakers Ltd. v. Barnet Investments Ltd. [1944] 2 All ER 579
Sajan Singh v. Sardara Ali [1960] MLJ 52 [1960] 1 All ER 269

Legislation referred to:
Companies Act 1965, ss. 16, (1), (5), 361
Forest Rules 1356 (Trengganu), r. 20(1), (4)

Other sources referred to:
Palmer's Company Law, 21st Edn., pp. 119-123

For the plaintiff - Gurbakhash; M/s Gurbakhash Singh & Co.
For the defendant - S.E Rajah; M/s S.E Rajah & Co.

JUDGMENT

Salleh Abas FJ:

In this case Counsel for both parties agreed not to call oral evidence. They relied upon the facts as disclosed in the pleadings and the agreed bundle of documents, which are as follows.

Upon being told by the State Forest Officer that their application to erect a sawmill at Balu Rakit was approved, the defendant No. (1) and Cik Chik bt. Haji Mohamed (not a party to this suit) signed two agreements with the plaintiff. The first agreement was signed on 6 July 1972, whilst the second one on 13 December of the same year. These two agreements, identical in terms, made provision for the incorporation of a company to be named as Perusahaan Kayu Rakit Sdn. Bhd. (in this judgment referred to as the company) "to work the said sawmill licence" with a RM200,000 capital of which 75% was to be held by the plaintiff and the remaining 25% by the defendant No. (1) and Cik Chik. It was also agreed that the management and control of the company was to be the sole responsibility of the plaintiff. Accordingly the company was incorporated on 18 November 1972 and the licence to erect and operate a sawmill was issued to the defendant No. (1) and Cik Chik on 7 June 1973. The company has since been operating its sawmill presumably by relying upon this licence. Subsequently a dispute arose between the plaintiff and the defendant No. (1) and the dispute was finally settled by the plaintiff opting out of the company and selling all his shares to the defendant No. (1) for RM55,000. As the defendant No. (1) was unable to make immediate payment for these shares, on 24 May 1974 he and the defendant No. (2), (3) and (4) and the plaintiff signed a guarantee agreement whereby in consideration of the plaintiff accepting delayed payment for the shares the other three defendants gave a guarantee for such payment. The defendant No. (1) has so far paid RM12,000, and refused to pay the outstanding balance of RM43,000. When sued for the recovery of this amount, all the four defendants claimed that

the sale of shares to the defendant No. (1) and the guarantee agreement were illegal and that the plaintiff's suit should therefore be dismissed. The defendants also counterclaimed for the return of RM12,000 previously paid to the plaintiff on the ground that the payment was made under a mistake of law.

At the start of the hearing before me Counsel for both sides agreed to submit for my decision without calling any oral evidence an issue of law whether or not the guarantee agreement was illegal. If so, Counsel agreed that the plaintiff's claim should be dismissed and if it is otherwise judgment for the plaintiff in the sum of RM43,000 should be entered. The counterclaim of RM12,000 was dropped. In my view this was rightly done because if the payment was made under an illegal contract as was contended by the defendants under no circumstances could they rely upon that same contract to recover the amount so paid. Hence the dropping of the counterclaim was properly done.

The sawmill licence in this case authorises

> the defendant No. (1) and Cik Chik to erect and/or operate a sawmill at Batu Rakit to be known as the Perusahaan Kayu Batu Rakit Sdn. Bhd. for the period or periods specified below subject to the following conditions ...

One of the conditions is condition No. (1) in that the licence shall not be transferable. In my judgment so long as the company was owned and managed by the defendant No. (1) and Cik Chik, by lifting the veil of incorporation it could be held that they have erected and operated the sawmill and that the company's operation was within the terms of the licence. But where the company was virtually wholly owned by the plaintiff and completely managed by him, the defendant No. (1) and Cik Chik could not be held to have erected and operated the sawmill. Consequently the company could not be held to have operated within the terms of the licence as it was not authorised by it, nor did the licence permit its transferability to the company. Thus Counsel for the defendants was correct when he submitted that the two agreements signed on 6 July and 13 December 1972, pursuant to which the company was incorporated were illegal as the agreements amounted to an attempt to circumvent the condition of the licence as to its non-transferability to non-licences. But with respect I do not accept his submission that the incorporation of the company itself was illegal just because the agreements as to its formation were illegal.

It must be observed that the company is not the creature of these two agreements, although the parties thereto agreed that it should be incorporated. The existence of the company is the result of the statutory acts of the Registrar of the Companies under s. 16 of the Companies Act in registering the company and its memorandum and articles and in issuing a certificate of its incorporation. The effect of these acts is that as from the date specified in the certificate the subscribers, i.e. the plaintiff and the defendant No. (1) together with Cik Chik became "a body corporate" by the name of Perusahaan Kayu Batu Rakit Sdn. Bhd. capable forthwith of exercising the functions of an incorporated company (*vide* s. 16(5). As to the evidence of its valid existence s. 361 of the Companies Act provides that:

> A certificate of incorporation under the hand and seal of the Registrar shall be conclusive evidence that all the requirements of this Act in respect of registration and of matters precedent and incidental thereto have been complied with, and that the company referred to therein is duly incorporated under this Act.

This provision makes it impossible for anyone to challenge the lawfulness and validity of the existence of the company although it does not go so far as to say that the company's objects and powers contained in the memorandum are either lawful or lawfully exercisable. To put it in another way, a certificate of incorporation prevents any doubt from being cast

upon the legal existence and the persona of the company but it does not validate its illegal objects. Of course a company pursuing an illegal object should not be registered and the Registrar is entitled to refuse the registration of such company and his refusal is reviewable upon an application on *mandamus*, (*R. v. Registrar of Joint Stock Companies* [1931] 2 KB 197, but once the company is registered the Court has to accept and recognise its valid and lawful existence until it is wound up or until its registration is cancelled at the suit of the Attorney-General on account of its registration for an illegal object (see *Palmer's Company Law*: 21st Edn., pp. 119-123).

Thus having regard to the provisions of ss. 16 and 361 of the Companies Act, the view I take of this case is that the incorporation of Perusahaan Kayu Batu Rakit Sdn. Bhd. was completely lawful, although its operation of the sawmill, being an operation without a licence required by r. 20(1) of the Trengganu Forest Rules 1356 is illegal and the company may well be liable to be punished by daily fines as provided in r. 20(4). The licence was not issued to the plaintiff nor could it be transferred to him, and as the plaintiff by virtue of his full control and shareholding, is in fact the alter ego of the company the operation of the sawmill when the company was thus constituted is illegal; the elements of illegality being the plaintiff's full control and management as well as shareholding in the company *vis-a-vis* the licence. But where the defendant No. (1) and Cik Chik themselves have the full control and ownership as effected by the plaintiff selling all his shares to the defendant No. (1) the company's operation comes exactly within the terms of the licence and is therefore not illegal. It is with a view to get rid of the elements of illegality that the plaintiff divested himself of the control and management of the company by selling all his shares in it to the defendant No. (1) and that in order to ensure that he would ultimately receive the price of these shares, the plaintiff and the defendant No. (1) together with three other defendants entered into the guarantee agreement on 24 May 1974. Thus the basis of the plaintiff's claim against the defendant No. (1) is the sale of his shares whilst his claim against the other three defendants is founded on the guarantee given in the said agreement. Counsel for the defendants submitted that the sale of shares and the guarantee were illegal because the incorporation of the company was illegal and so the plaintiff should not be able to recover any payment from any or all of those four defendants. With respect I do not think that the submission is correct in view of the fact that the incorporation of the company is an independently legal and valid act of the Registrar of Companies.

As regards the sale of shares I cannot see anything illegal in the transaction. There is nothing illegal about its capital structure and the plaintiff's share holding as the company is validly incorporated and has a valid existence. The previous two agreements following which the company was formed were irrelevant and could not render the plaintiff's share ownership in the company illegal. That being, the case, the subsequent sale of the shares by the plaintiff to the defendant No. (1) and the guarantee given by the other three defendants against failure of the defendant No. (1) to pay the price of these shares were also not illegal.

I draw support for my judgment from the principle established in *Bowmakers Ltd. v. Barnet Investments Ltd.* [1944] 2 All ER 579, 582 which principle was later accepted and applied by the Privy Council in *Sajan Singh v. Sardara Ali* [1960] MLJ 52; [1960] 1 All ER 269. The principle is that where the plaintiff's claim is wholly independent of the alleged illegal contracts, there is no question of applying, the maxim *ex turpi causa non oritur actio.* Thus it was held that the plaintiff was entitled to claim his property which was being detained or converted by the defendant to his use, even though the property came into the latter's possession as a result of an illegal contract.

Further during the course of Counsel's submissions in the present case before me, I was referred to the judgment of Datuk Mohamed Zahir J in *Devanai v. Chinniah & Ors.* Kuala Trengganu Civil Suit No. 41 of 1967 (unreported). Lest I might be misunderstood to have taken a different view from that of the learned Judge, I should explain that case as follows. The plaintiff was the proprietress of a sawmill business named Kapur Sawmill. The sawmill licence for this business was issued in the name of the business. Later she sold the business to the defendant No. (1) who subsequently formed a partnership with the other two defendants and some other persons to run the sawmill business. Although the plaintiff had completely divested herself of this business, the defendant No. (1) had not yet fully paid the sale price of the business. Consequently the plaintiff sued for the rescission of the sale the plaintiff agreement and for a declaration that she was still the owner of the business. She also claimed the balance of the sale price of the business. The learned Judge dismissed her claim for rescission and declaration, but allowed the claim for the balance of the sale price. The learned Judge refused to allow claim for rescission and declaration, because in his judgment the sale agreement transferring the business from the plaintiff to the defendant No. (1) and the partnership agreement transferring it further from this defendant to the partnership were both illegal contracts. They were illegal because the transfers must necessarily include dealings with the requisite sawmill licence, and as the licence was not transferable such dealings were contrary to the provisions of r. 20 of the Trengganu Forest Rules 1356. Hence the contracts were illegal. It is observed that despite the illegality of the sale agreement, the plaintiff was held to be entitled to the balance of the sale price of the business. The learned Judge gave no reason for allowing the plaintiff to recover the balance of the sale price, but in my view her entitlement could be justified on the ground that the transfer of business to the defendant No. (1), even though under the illegal sale contract, was effective as this transfer did not depend upon, but was independent of, the transferability of sawmill licence. Hence the case came within the principle established in *Bowmakers Ltd. v. Barnett Investment Ltd. supra* and *Sajan Singh v. Sardara Ali, Supra.*

Now reverting to the present case, I hold that although the previous two agreements were illegal, the incorporation of the company was a perfectly lawful exercise as the company was not the creature of these two agreements but created by the statutory acts of the Registrar of the Companies under s. 16 of the Companies Act. Whilst its operation to run the sawmill was illegal as it had no sawmill licence to cover such operation, the sale of shares and the guarantee agreement for the purpose of making the company's operations come within the ambit of legality were not illegal. Hence there should be a judgment entered for the plaintiff in the sum of RM43,000 and costs.

Also found at [1982] CLJ 201